Internal Revenue Service
memorandum

CC:TL:Br3
JHBosley

date: DEC 10 1990

to: District Counsel, Cleveland C:CLE
ATTN: Robert W. Kern, Special Litigation Assistant

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: Technical Advice - [redacted], Deductibility of [redacted] VEBA Trust Contributions.

We have been requested to provide technical advice with respect to the above corporation and issue.

ISSUE

Whether [redacted] may properly deduct in the [redacted] taxable year a contribution of $[redacted] made to [redacted] (hereinafter "Trust") to fund group insurance medical benefits for its active and retired employees.

CONCLUSION

We believe that disallowance of the subject contribution can be defended on the basis of the capitalization doctrine.

FACTS

The Trust purportedly qualifies for tax exempt status under I.R.C. § 501(c)(9) as a voluntary employees' beneficiary association (VEBA). On [redacted], [redacted] established the Trust in order to fund the benefits provided under various welfare benefit plans maintained for its employees. When the Trust was established, an exemption application was filed with the Service.

In [redacted], prior to the funding, [redacted] refiled the application for recognition of exemption for the Trust because the board of directors felt such a long period of time had elapsed since the original filing. It was not until [redacted], that VEBA began functioning: on that date, the [redacted] board of directors resolved to include in its VEBA Trust the company's health, accident, and death benefit plans related to

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1 [redacted] was the founding parent corporation of [redacted].

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its health insurance and severance programs. (See attached "Comments on Protest" page 1).

The plans funded by the Trust apparently provide for a number of welfare benefits, including medical insurance. On [redacted], [redacted]'s board of directors approved a contribution of $[redacted] to the trust from a distribution of retrospective premiums held by the [redacted]. This "reserve" (as it has been called by [redacted]) was, according to [redacted], "calculated as being reasonable on an actuarial basis by our actuary." ([redacted]'s Position Paper on Proposed Adjustment #7, page 1, copy attached). It is not clear how [redacted]'s actuary determined this amount.

The trust made no medical claim payments during [redacted] and [redacted]. All [redacted] and [redacted] medical claims were paid by the taxpayer through a third-party administrator, and the taxpayer claimed a deduction for the payments made. (District Counsel, Cleveland, Ohio Memorandum of June 6, 1990, copy attached). The taxpayer presumably uses the accrual method of accounting for income tax purposes.

DISCUSSION

The deductibility of [redacted]'s [redacted] $[redacted] VEBA Trust contribution is governed by I.R.C. §§ 162 and 461. See, e.g., Treas. Reg. § 1.162-10 and Temp. Treas. Reg. § 1.419-1T (Q&A-10(b)). While the taxpayer properly accrued the VEBA Contribution in [redacted],[2] we believe that the contribution was subject to capitalization, and hence not deductible until expended in later years.

In general, the requirements of I.R.C. § 162(a) are directly applicable in determining the deductibility of contributions to employee benefit plans, such as those involved here, prior to effective date of I.R.C. § 419. See Treas. Reg. § 1.162-10(a); Rev. Proc. 87-55, 1987-2 C.B. 671 (§2.02). See also Lundy Packing Co. v. United States, 302 F. Supp. 182, 185 (D.N.C. 1969), aff'd 421 F.2d 850 (4th Cir. 1970). In order to be deductible under I.R.C. § 162(a), an expenditure must be both "ordinary and necessary." E.g., Commissioner v. Lincoln Savings & Loan Assn., 403 U.S. 345, 352 (1971). In this regard, it has long been understood that the primary function of the "ordinary" requirement is to differentiate between capital expenditures and current expenses. See, e.g., Lincoln Savings & Loan Assn., at 353. In principle, the more recent case law makes clear that "expenditures to acquire assets or secure benefits which last beyond the taxable year must be capitalized...." Seligman v. Commissioner, 84 T.C. 191, 201 (1985) (emphasis added). Accord,

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2 See discussion, infra, at page 4.

e.g., Modern American Life Insurance Co. v. Commissioner, 830 F.2d 110, 112 (8th Cir. 1987). As the Eighth Circuit observed in Modern American Life Insurance Co., this "fundamental proposition of tax law" applies to "expenses incurred in acquiring an asset or economic interest, benefit or advantage - whether tangible or intangible ...." Id., at 112. See, e.g., National Starch and Chemical Corp. v. Commissioner, at 76.

The [redacted] VEBA Trust contribution is not unlike Sebring v. Commissioner, 93 T.C. 220 (1989), in which the deductibility of contributions to an indemnity fund for bail bondsmen was at issue. In holding that such contributions must be capitalized, the court noted that "a contribution to a reserve for future liabilities is not deductible; only actual payment out of the reserve to satisfy a definite liability can give rise to a deductible expense...." Id., at 225. Because the contributions at issue are going into a trust for the "future liabilities" of [redacted], the same result should obtain here.

Under Q&A-10(c) of §1.419-1T, I.R.C. § 7805(b) relief is given for pre-1986 years for those deductions which satisfy the standards applied in Rev. Rul. 69-382, 1969-2 C.B. 28, Rev. Rul. 69-478, 1969-2 C.B. 28, and Rev Rul. 73-599, 1973-2, C.B. 32, as modified for active lives. As reflected in the VEBA Audit Guideline (copy attached), relief is to be provided to the extent that the applicable standards set forth in the above cited revenue rulings are satisfied. VEBA Audit Guideline, at 4. The VEBA Audit Guideline, while not technically binding in litigation, was designed to define the extent to which funding issues would be pursued for pre-1986 years. It was generally intended that the Service would not litigate proposed adjustments that were not recognized under the VEBA Audit Guideline.[3] Accordingly, only that portion of a disputed contribution which exceeds those standards should be pursued.

Revenue Rule 73-599 is relevant here in determining the availability of Q&A-10(c) relief. That Revenue Rule states:

> [a]nnual contributions by the taxpayer to the fund...will constitute business expenses deductible under section 162 of the Code only to the extent that such contributions are actuarially determined and made on a level basis....[O]ut of the entire amount transferred from the insurance company to the trust...the taxpayer may have that portion that is actuarially determined and made on a level basis

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[3] The VEBA Audit Guideline is available to the public. A litigating hazard would be created if Guideline standards were inapposite to the position taken by the Service in litigation and this discrepancy was brought to the court's attention.

> represent its otherwise payable annual contribution to the fund and only to that extent will it constitute a deduction under section 162 in the year of transfer....[T]he excess shall constitute a prepayment of future annual contributions.

Applying these standards here, the taxpayer has apparently not provided anything which demonstrates what would be an actuarially determined level amount for the subject plan. This is supported by the fact that the Trust was inactive for two years. In short, Q&A-10(c) relief is not available in the circumstances presented here.

Finally, questions regarding the applicability of the "all events" test embodied in Treas. Reg. § 1.461-1(a)(2) must be addressed. The "all events" test defined by the United States Supreme Court in United States v. General Dynamics Corp., 481 U.S. 239 (1987), concerned an unfunded medical plan. [redacted]'s VEBA Trust was funded. Since General Dynamics Corp., where a welfare benefit plan is funded, it is the Service's litigating position that the "all events" test (which is codified in I.R.C. § 461(h)) is satisfied when the contribution is made to the trust. As a result, the "all events" test has been satisfied by [redacted] and cannot be used in characterizing [redacted]'s VEBA contribution as an expense. Additionally, the prepayment doctrine found in the "all events" test applies to cash basis taxpayers only and therefore is inapplicable to the [redacted] fact pattern.

If you need any further assistance in this case, please contact J. H. Bosley of the Tax Litigation Division at FTS 566-3407.

MARLENE GROSS

By:

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Attachments: As stated.